**Office of Chief Counsel**
**Internal Revenue Service**

# memorandum

CC:NER:MIC:DET:TL-N-5070-99
GEGabriel

date: May 15, 2000

to: Larry I. Walter
National Inventory Issue Specialist

from: Grant E. Gabriel
National Inventory Issue Specialist Counsel

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subject: [redacted]
**LIFO Pooling**

This memorandum responds to your request for assistance regarding the above-referenced case, Specifically, you requested us to opine whether the taxpayer would be permitted to pool based on the Producer Price Index (PPI) categories under the Inventory Price Index Computation (IPIC). The advice in this memorandum is subject to post-review in the National Office. Accordingly, please do not share this advice to the exam team until we receive National Office validation.

## DISCLOSURE STATEMENT

This advice constitutes return information subject to IRC. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

## ISSUE

Under what circumstances may [redacted] change its method of dollar-value last-in, first-out (LIFO) pooling under the IPIC method from pooling by natural business unit (NBU) to pooling based on the 15 producer price index (PPI) categories?

## CONCLUSION:

Although taxpayer may not change from NBU pooling to pooling by PPI category pursuant to the automatic consent procedures set forth in Rev. Proc. 99-49, 1999-52 IRB. 725, it may request permission to change, with the District Director's consent, in accordance with Rev. Proc. 97-27, 1997-21 IRB 11. If its application is approved then taxpayer could change its method of pooling from NBU pooling to pooling by PPI categories. However, this change would be done on a cut-off basis (without a § 481(a) adjustment) Alternatively, the exam team could initiate the accounting method change (with a § 481(a) adjustment) to the extent taxpayer's use of a single NBU does not clearly reflect income and to the extent the applicable PPI categories are consistent with the multiple pooling rules set forth in Treas. Reg. § 1.472-8(b)(3).

## FACTS

Taxpayer is a producer of consumer products. Many of these products are produced from [redacted] that taxpayer buys and sells in part for use as raw materials in its production operations. Taxpayer's inventories transcend 3-6 PPI categories. [redacted] uses the Inventory Price Index Computation (IPIC) method set forth in Treas. Reg. § 1.472-8(e)(3). In conjunction with using the IPIC method, taxpayer pools by NBU. The Examining Agent has determined that maintaining a single NBU does not clearly reflect income and has provided taxpayer with an Information Document Request (IDR) specifically rendering its pooling method an "issue under consideration."

## LAW

Section 472(a) of the Code allows a taxpayer to elect the LIFO inventory method. The use of the LIFO method, however, must be in accordance with the regulations, must be applied on a consistent basis, and must clearly reflect income.

Treas. Reg. § 1.472-8(b)(1) provides an NBU pool shall consist of all items entering the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in § 1.472-8(b)(3).

Treas. Reg. § 1.472-8(b)(3) provides a taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the natural business unit method of pooling. Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. Raw materials which are substantially similar shall be pooled together. Finished goods and goods in process in the inventory shall ordinarily be placed into pools classified by major classes or types of goods.

Treas. Reg. § 1.472-8(e)(3)(i) authorizes taxpayers to determine their price indices in accordance with prescribed external indices published by the Bureau of Labor Statistics (BLS).

Treas. Reg. § 1.472-8(e)(3)(iii)(c) provides that manufacturers, processors, wholesalers, jobbers, and distributors may select indexes from only the Producer Prices and Price Indexes.

Treas. Reg. § 1.472-8(e)(3)(iv) provides a retailer, wholesaler, jobber, or distributor computing an inventory price index may, at the option of the taxpayer, establish an inventory pool for any group of goods included within one of eleven general categories of consumer goods described in the CPI detailed report.

Rev. Proc. 84-57, 1984-2 CB 496, in setting forth guidance on how to use the IPIC method provides, at section 3.04.1(a), a retailer wholesaler, jobber or distributor may establish an inventory pool or pools included within the 11 categories of consumer goods described in the CPI detailed report. Section 3.04.1(b), Rev. Proc. 84-57 provides an inventory pool may be established for any group of goods included within one of the 15 general categories of producer goods. Section 3.04.2, Rev. Proc. 84-57, provides manufacturers and processors may establish natural business unit pools in accordance with Treas. Reg. § 1.472-8(b). Section 3.04.3, Rev. Proc. 84-57, provides that inventory categories may be grouped into multiple pools consisting of inventory categories that are substantially similar. Important considerations for establishing these pools are enumerated in § 1.472-8(b)(3).

Rev. Proc. 99-49, 1999-52 I.R.B. 725, *clarifying, modifying, amplifying and superceding* Rev. Proc. 98-60, 1998 -51 IRB 16, permits taxpayers to obtain automatic consent to change certain methods of accounting. Taxpayers under examination may also use this revenue procedure provided that they are within a prescribed window period (if the method of accounting the taxpayer is requesting to change is not an issue under consideration). Alternatively, a taxpayer under examination may make a change in method of accounting with the consent of the District Director (section 6.03(4)).

Section 10.04(a), APPENDIX to Rev. Proc. 99-49, specifically permits taxpayers to obtain automatic consent to change their LIFO inventory methods to the IPIC method for their entire LIFO inventories in accordance with all of the provisions of § 1.472-8(e)(3) and Rev. Proc. 84-57, 1984-2 CB 496. Section 10.04(c), APPENDIX, Rev. Proc. 99-49, provides that a taxpayer may not change its method of pooling as part of its change to the IPIC method except to a method of pooling specifically authorized by Treas. Reg. § 1.472-8(e)(3)(iv) or section 3.04(1)(b) of Rev. Proc. 84-57. These special pooling rules do not apply to goods manufactured by the taxpayer. *See* § 1.472-8(b) for principles for establishing pools of manufacturers and processors.

Section 446(b) and Treas. Reg. § 1.446-1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in the manner that, in the opinion of the Commissioner, does clearly reflect income.

Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

## DISCUSSION AND ANALYSIS

As a preliminary matter, this opinion is restricted to taxpayer's production activities and, therefore, does not consider pooling requirements for any resale activity taxpayer may be engaged in.

Both Rev. Proc. 99-49 ("mass automatic") and Rev. Proc. 97-27 only permit taxpayers under examination to apply for changes in methods of accounting within the prescribed 90-day and 120-day window periods. Moreover, both these pronouncements prohibit taxpayers from using these windows to apply for an accounting method change for an issue that is "under consideration." In this case, the Examining Agent has provided the taxpayer with an IDR specifically placing its LIFO pooling method under consideration[1]. Accordingly, the Service would only accept an application for a change in method of LIFO pooling with the consent of the District Director (or appropriate examining office or official).

Rev. Proc. 99-49, however, only provides automatic consent for changes to the IPIC method, not within the IPIC method. Because [redacted] is already using the IPIC method, a change from pooling by NBUs to pooling by PPI categories is not within the scope of Rev. Proc. 99-49[2].

Although the taxpayer could request to change its IPIC pooling method under the provisions of Rev. Proc. 97-27, such a request would only be accepted with the consent of the District Director (or other appropriate examining office or official). In this case the taxpayer's present method of accounting at issue would otherwise give rise to an adjustment for the years under examination. If an appropriate authority granted this consent the accounting method change would be made on a cut-off basis and,

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[1]Section 3.08(1), Rev. Proc. 97-27 provides that a question of whether a method of accounting is an issue under consideration may be referred to the National Office as a request for technical advice.

[2]Section 10.04(1)(c)(APPENDIX), Rev. Proc. 99-49.

therefore, there would be no resulting § 481(a) adjustment[3].

Provided taxpayer's use of a single NBU pool does not clearly reflect income, the Service could initiate a change in taxpayer's method of pooling under the IPIC method[4]. The Commissioner has broad discretion in selecting a method of accounting that he believes properly reflects the income of a taxpayer once he has properly determined that a taxpayer's present method of accounting does not clearly reflect income. Under a service-initiated accounting method change, a § 481(a) adjustment is required except in those rare and unusual circumstances when the Examining Agent determines that the taxpayer's books and records do not contain sufficient information to compute an adjustment and the adjustment is not susceptible to reasonable estimation[5].

Pooling by PPI category in conjunction with using the IPIC method is not expressly permitted under the regulations. Section 1.472-8(e)(3)(iv) provides a retailer, wholesaler, jobber, or distributor computing an inventory price index may, at the option of the taxpayer, establish an inventory pool for any group of goods included within one of eleven general categories of consumer goods described in the CPI detailed report.

Section 3.04.2, Rev. Proc. 84-57 provides manufacturers and processors may establish natural business unit pools in accordance with Treas. Reg. § 1.472-8(b). Section 3.04.3, Rev. Proc. 84-57 provides that inventory categories may be grouped into multiple pools consisting of inventory categories that are substantially similar. Important considerations for establishing these pools are enumerated in § 1.472-8(b)(3).

Essentially, neither Treas. Reg. § 1.472-8(e)(3) nor Rev. Proc. 84-57 provide IPIC-specific methods of pooling for manufacturers and processors. Accordingly, only the principles set forth in Treas. Reg. § 1.472-8(b) apply. Section 1.472-8(b)(1)

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[3]Section 5.02(3)(b), Rev. Proc. 97-27 (addressing procedures for taxpayers not under examination provides that changes within the LIFO method must be made using a cut-off. However, Announcement 91-173 (relating the separate item requirement for "bargain purchases" is an example of "other published guidance" that would require a § 481(a) adjustment. Presumably, these same provisions apply to a taxpayer under examination that has received consent from the District Director to file a request for change in method of accounting.

[4]The Commissioner has broad discretion in determining whether a taxpayer's method of accounting clearly reflects income, and the Commissioner's determination must be upheld unless it is clearly unlawful. See *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522(1979); *RCA Corp. v. United States*, 664 F.2d 881 (2nd Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982). However, the determination of the proper number of NBU pools is highly factual and outside the scope of this advisory opinion.

[5]*See* section 5.04, Notice 98-31, 1998-22 IRB 10.

provides that under NBU pooling the entire production activity within the NBU, including raw materials, goods in process and finished goods, must be included in the NBU pool. Thus, NBU pooling is potentially inconsistent with pooling by PPI category because the PPI categories may include raw materials as a separate category and, therefore, would constitute a separate pool.

In contrast, the multiple pooling rules set forth in Treas. Reg. § 1.472-8(b)(3) may very well support a pooling configuration based on PPI categories. Section 1.472-8(b)(3)(i)(a) provides that each pool shall consist of a group of inventory items that are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. Section 1.472-8(b)(3)(i)(b) provides that raw materials which are substantially similar shall be pooled together. Section 1.472-8(b)(3)(i)(c) provides that finished goods and goods in process shall be placed into pools classified by major classes or types of goods.

In summary, although pooling by PPI categories is not a per se acceptable method of pooling under the IPIC method, these categories may be, depending on the facts and circumstances, an acceptable configuration under the multiple pooling rules set forth in Treas. Reg. § 1.472-8(b)(3). These rules require substantially similar raw materials to be pooled together and work in process and finished goods to be pooled by major lines or classes of goods. To the extent the PPI categories are consistent with the multiple pooling rules, and to the extent taxpayer's use of a single NBU does not clearly reflect income, Exam could initiate an accounting method change from a single NBU to multiple pooling based on PPI categories. For example, taxpayer's goods potentially could be grouped in pools based on [redacted], [redacted] and the product categories that include its packaging materials.

We note that the Examining Agent may determine that changing taxpayer's pooling to multiple NBU pools is more appropriate. This would again depending on the specific facts and circumstances relating to the composition of taxpayer's inventory.

GRANT E. GABRIEL
Special Litigation Assistant